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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C. 20554

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APR 28 2000

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers	)	CC Docket No. 98-137
	)	
Ameritech Corporation Telephone Operating Companies Continuing Property Records Audit, *et. al.*	)	CC Docket No. 99-117
	)	
GTE Telephone Operating Companies Release of Information Obtained During Joint Audit	)	CC Docket No. 98-26

AFFIDAVIT OF
DR. MARK N. COOPER
ON BEHALF OF THE
CONSUMER FEDERATION OF AMERICA,
TEXAS OFFICE OF PUBLIC UTILITY COUNSEL, AND
CONSUMERS UNION

STATE OF MARYLAND §
§
COUNTY OF MONTGOMERAY §

I, Mark N. Cooper, on my oath do hereby depose, swear and state as follows:

I. BACKGROUND

A. QUALIFICATIONS

My name is Mark N. Cooper. I am President of Citizens Research. I am also Director of Research of the Consumer Federation of America (CFA). Prior to founding Citizens Research in 1983, a consulting firm specializing in economic, regulatory and policy analysis, I spent four years as Director of Research at the Consumer Energy Council of America. Prior to that I was an Assistant Professor at Northeastern University teaching courses in Business and Society in the College of Arts and Sciences and the School of Business. I have also been a Lecturer at the Washington College of Law of the American University co-teaching a course in Public Utility Regulation.

I have testified on various aspects of telephone and electricity rate making before the public utility commissions of 29 states, the District of Columbia, and Manitoba as well as the Federal Communications Commission (FCC), the Canadian Radio-Television and Telephone Commission (CRTC) and a number of state legislatures.

For a decade and a half I have specialized in analyzing regulatory reform and market structure issues in a variety of industries including telecommunications, railroads, airlines, natural gas, electricity, medical services and cable television. This includes approximately 300 pieces of testimony presented to state regulatory bodies, federal legislative bodies, and federal administrative bodies.

I have written several major works on universal service and the impact of rising prices for utilities on consumer in general and low income households in particular. These include *Equity and Energy: Rising Energy Prices and the Living Standards of Lower Income Americans*

(Westview Press: Boulder, 1982), "protecting the Public Interest in the Transition of Competition in Network Industries," *The Electric Utility Industry in Transition* (Public Utilities Reports, Inc., 1994); *Universal Service: A Historical Perspective and Policies for the Twenty-First Century* (Benton Foundation and the Consumer Federation of America, 1996).

B. SUMMARY OF ARGUMENT

On behalf of the Consumer Federation of America, the Texas Office of People's Counsel and Consumers Union I respectfully submit this affidavit in response to comments filed in the above-captioned proceeding.[1] It was just three months ago that the Federal Communications Commission concluded a detailed review of its depreciation prescription rules for price cap ILECs and set forth a number of specific conditions that an ILEC must meet before waivers of its depreciation prescription rules to be deemed appropriate.[2] The Commission emphasized that its specific conditions were absolutely necessary to protect consumers against harmful rate impacts and to limit any harmful impact on competition.

In comments filed in response to the *Further Notice* the Commission has been urged to abandon those principles and to adopt a new proposal from the price cap incumbent local exchange carrier ("CALLS ILEC")[3] that would radically depart from the Commission's previously adopted rules. The treatment of the discrepancy between the regulatory and the financial books of local exchange companies proposed by the members of CALLS is unjust and

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[1] Further Notice of Proposed Rulemaking, *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket Nos. 98-137, 99-117, AAD File No. 98-26 (April 3, 2000)("*Further Notice*").
[2] *See* Report and Order, *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, CC Docket Nos. 98-137 et al. (December 30, 1999)("*Depreciation Order*").
[3] *See* March 3, 2000 Letter from Robert T. Blau, Vice-President-Executive and Federal Regulatory Affairs, BellSouth, to Ms. Magalie Roman Salas, Secretary, Federal Communications Commission ("*CALLS ILEC Letter*").

unreasonable and should be rejected. The treatment allows the companies to reflect those costs as charges against income that could be recovered from ratepayers at some point in time in either the federal or state jurisdictions. Several commentors suggest that it is their intention to do so.[4] This would constitute a blatant, double recovery of costs that violates the fundamental principle of just and reasonable rates. Under no circumstances should the Commission give any legitimacy or to open the door to the double recovery of these costs.

The waiver proposal contained in the *CALLS ILEC Letter* dramatically differs from primary goal of the Commission's *Depreciation Order* by requesting a five-year amortization instead of the one-time write-off approach preferred in the Commission's *Depreciation Order*. Since the amortization reduction sought for assets already written off the companies' financial books is substantial, $28 billion, the implications are significant. Given the intentions of the companies, it will cost consumers dearly in the future, as it already has in the past.

The waiver proposal would also render moot the Commission's audits of the continuing property records ("CPR") of the Regional Bell Operating Companies ("RBOCs") and GTE. The first phase of these audits (covering just 23% of the total company assets) found that at least $5 billion of central office equipment was unaccounted for. The audits clearly determined that at least 10% of the assets audited were not in service. The audits correctly recommended (as did the depreciation order) that these assets be written off the carriers' books and that new inventories be conducted so that their records would come in compliance with Commission rules. Amortizations and write-offs are very different. A write-off would immediately <u>reduce</u> reported costs. Conversely, an amortization would <u>increase</u> reported costs over a period of time, 5 years in this case. The waiver

[4] Bell South, pp. 2-4, SBC, pp, 4-8.

proposal's 5-year amortization would do nothing to correct the inaccuracies in the carriers' CPR records.

II. THE RELATIONSHIP BETWEEN REGULATED COMPANIES AND RATEPAYERS

The key question raised in this proceeding is the nature of the commitment that ratepayers have to allow the recovery of the costs incurred by regulated utilities. The local exchange companies assert that they have a virtual guarantee to recover those costs, even though they have long since been written off for financial purposes. That is simply not the case. There never was an implicit or explicit guaranteed return of or on capital. Claims that a regulatory compact or constitutional protections bind ratepayers to make utilities whole for every penny of investment they have made or every obligation they have incurred have no legal basis.

Utilities are and have always been obligated to provide economic service and be efficient with no claim to recover inefficient costs. Efficiency would be the outcome of a competitive market and that is the outcome which regulation has always tried to achieve. Unanticipated events on the demand-side or the supply-side are part of the risk for which utilities have been compensated. Management exercised substantial discretion in the decisions to make investments. Management must bear the responsibility for its own actions. The burden of strategic actions or mistakes should be borne by stockholders, not ratepayers.

In a competitive market, investments that made sense at one moment in time are frequently rendered uneconomic by technological progress or market change. Just because they were prudent at one moment in time does not ensure their soundness over time. Competitive sector companies frequently find that they cannot recover the cost of investment because of technological and market changes. No matter how prudent an initial decision, events, circumstances, technological change, behavioral changes, or just plain bad luck can render those decisions uneconomic, imposing loses on a company. That is a risk they face and for which they are generally compensated in their return on capital.

All that a firm can expect in a competitive market is to recover efficient forward looking costs and firms are subject to the risk of stranding that result from market forces. The possibility of write-offs is not simply the result of regulation. Stranding of costs occurs where no regulation exists as the result of technology and market changes. The purpose of regulation has been to emulate the competitive market and regulated firms have known all along that treatment similar to what they would receive in a competitive market is all that regulated firms ever were entitled to. They never should have anticipated earning more than a fair return on their efficient forward looking costs.

Just like companies in a competitive marketplace, a utility is required to continually review the efficiencies of its operation compared to those around it and in light of new and emerging technologies. If the service rendered is not economic on a going forward basis, that is management's fault. Stockholders should bear the burden of write-downs necessary to restore the forward looking profitability of investment, just as companies in the marketplace do.

III. THE RISK OF WRITE-OFF IS ACCOUNTED FOR IN THE COST OF CAPITAL

Part of the market cost of capital already includes the risk of stranding costs which all industries face. All of the current methods for setting return on equity make reference to the capital markets and the performance of firms. Therefore, utilities are compensated for the risk of write-offs in their allowed rates of return.

Over seventy years, the Standard and Poor's 500 companies and the total of all companies on the New York Stock Exchange (which are the most frequent references) have suffered repeated instances of stranding of their investments. These have resulted from a variety of factors over a long period of time.

One source of stranded costs is large, unexpected changes in the economy, such as

- the great depression,
- World War II,
- the inflation that occurred after the Vietnam War, and
- the energy shocks of the 1970s.

A second source of stranded costs is major change in technology, such as

- the adoption of new steel production processes in the 1950s,
- the invention and commercialization of synthetic materials in the 1950s and 1960s, and
- the advent of microcomputers in the 1980s.

A third source of stranded costs is major change in government policy, such as

- changes in legal liability and safety regulation in the 1960s and 1970s,
- adoption of environmental laws in the 1970s and 1980s,
- adoption and removal of price controls in the 1970s, and
- deregulation in the 1980s and 1990s.

It is highly unlikely that capital markets have not taken the fact that assets can be stranded into account in determining the cost of capital. Not only is it highly likely that investors take the possibility of stranding into account in the risk premiums they require on non utility stocks, but it is hard to imagine investors not recognizing that disallowance of costs -- non-recovery of costs -- is part of the risk of investment in utility stocks. It is very difficult to imagine the mind-set of investors which would have not understood, even expected, the risk of stranded or write-off of costs. In simple regulatory terms, the risk of write off is deeply embedded in the expected returns.

The Federal Communications Commission, like every utility commission in the country that has allowed an investment to be included in rate base, has also assigned that investment a rate of return far above the risk free level in our society. The assignment of a return which includes a substantial risk premium clearly indicates that there were no guarantees being offered. If a return of or on capital were guaranteed, the Commission would have assigned a return without a risk premium.[5]

The Commission currently uses a return of 11.25 percent as the target, set in the early 1990s. Using the interest rate on a 10-year treasury note as a risk free rate of return, this constitutes a risk premium of about 5 percentage points. Because of the declining cost of capital over the 1990s and the failure of the Commission to lower the target rate of return, the risk premium implicit in rates has increased by about three percentage points (see Attachment MNC-

[5] Utilities have also been compensated with a virtual guarantee against bankruptcy. New revenue opportunities must also be taken into account in determining responsibility for investments, such as new markets or new geographic area which will be opened up.

1).

IV. GENERAL EMPIRICAL EVIDENCE THAT STRANDED COSTS ARE PART OF THE RISK PREMIUM

The obvious starting point for empirical analysis is to investigate the question of variability of returns. Returns to investors fluctuate widely and that is part of the expectation. Attachment MNC-2 shows the highs and lows of total returns to investors over the past 71 years. It is based on the results presented in Ibbotson Associates, Stocks, Bonds, Bills and Inflation 1997 Yearbook (1997). Returns show very large swings, not only above and below the average, but also positive and negative returns.

Year-to-year returns are highly volatile. Investors understand short term volatility and are always told to take a longer term view. For example, risk factors (Betas) are frequently calculated over a five year period. Attachment MNC-3 shows five year moving averages for the period from 1972 to 1992 for the S&P500 and the S&P400. The five year averages show less variability, but still a wide range of outcomes.

There is also direct evidence that the large companies which have been used as a basis for setting utility returns incur stranded costs. For example, A Goldman Sachs study (The Quality of Reported Earnings Has Improved, But..., January 2, 1997) demonstrates the importance of write-offs and charges against income. As Attachment MNC-4 shows, Goldman Sachs calculated the write-offs and charges against income per share and compared it to net income per share. Over the period 1988-1995, the write-off averaged 17 percent of income. These write-offs are equal to 14 percent of 1995 capitalization at the end of the period. That is, over the 1988-1995 period, companies took write-offs equal to approximately 14 percent of their 1995 capitalization. Over that same period, the S&P 500 earned a total return of 14 percent.

I have also conducted a specific study directly relevant to the current proceeding (see Attachment MNC-5). It is based on all the non-utilities that were included as comparison companies in the Commission's final proceeding to set AT&T□s rate of return. The proceeding was conducted in the mid-1980s, before the FCC adopted price cap regulation. I have chosen the non-utilities in the same, since utilities have refused to take any write-offs for regulatory purposes. I identified 34 companies on the FCC list for which data was available through 1995. Looking at the performance of non-regulated comparison companies is an explicit way of ascertaining the role of write-offs.

Based on Moody's reports, I have estimated the write-offs taken by these companies as a percentage of assets (at year end 1994/95). The results clearly show the significance of write-offs. Write-offs as a percent of assets are in the range of 3 to 138 percent. The average right off was 47 percent. The average total return for these companies was 10 percent. Because these comparison companies were chosen to reflect the lower level of risk faced by a regulated monopoly or dominant firm, they earn a somewhat lower return.

Even with the large write-offs, the comparison companies earned a total return ranging from slightly negative to about 20 percent. These companies have an average Beta of 1.05. Thus, they are close to the S&P500. The reality of write-offs is part of the expectations that investors have of the performance of companies in the marketplace.

The empirical evidence also shows a relationship between trade-offs and returns (see Attachment MNC-6). Firms that avoid write-offs are rewarded with higher total returns (capital markets bid up their price).

V. LOCAL EXCHANGE COMPANIES HAVE ALREADY BEEN COMPENSATED FOR THE RISK OF WRITE-OFFS

In this context, the local exchange companies have been handsomely rewarded, even with the write-offs that they have taken for financial purposes (see Attachment MNC-7). The major local exchange companies took write-offs of approximately 28 percent of assets for financial purpose. They earned a total return of 17 percent. This is an extremely high risk premium, sustained for more than a decade. This indicates that LECs have already been compensated handsomely for risks.

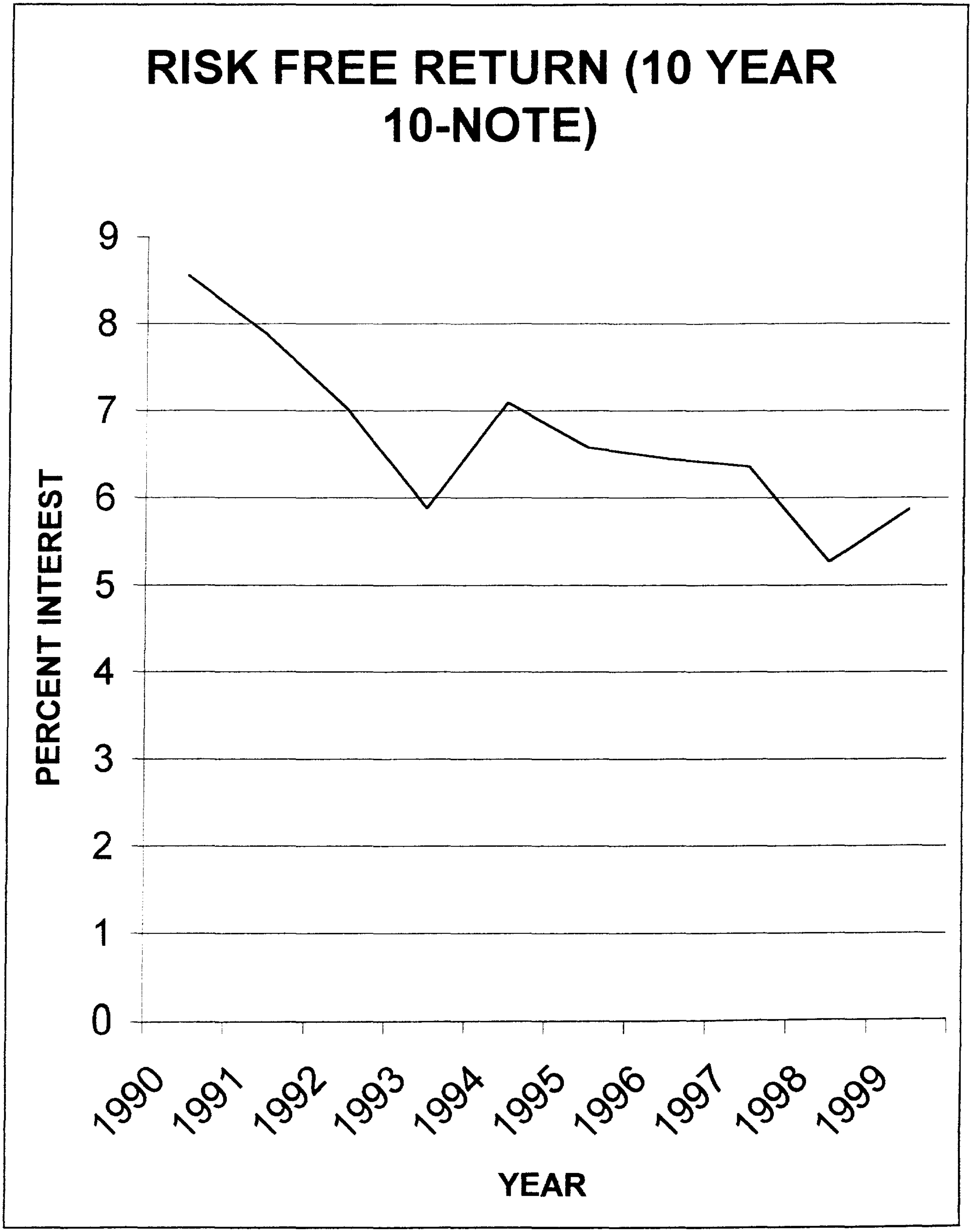
These are total returns to investors that include all of the assets and revenues of the companies. However, we observe a similarly excessive rate of return in the Federal jurisdiction (see Attachment MNC-8). Local exchange companies have consistently and repeatedly earned far in excess of the allowed rate of return, even though the written off assets are still included in the rate base. The total excess returns in the 1990s are in excess of $10 billion. This excess return is calculated on the inflated asset base (i.e. written-off assets included in the base depress the rate of return). Had the regulated asset base been written down, as the financial asset base was and as the comparison companies did, the rate of return would be even higher.

Moreover, the Commission has not adjusted its allowed return in many years, although the cost of capital has been declining.

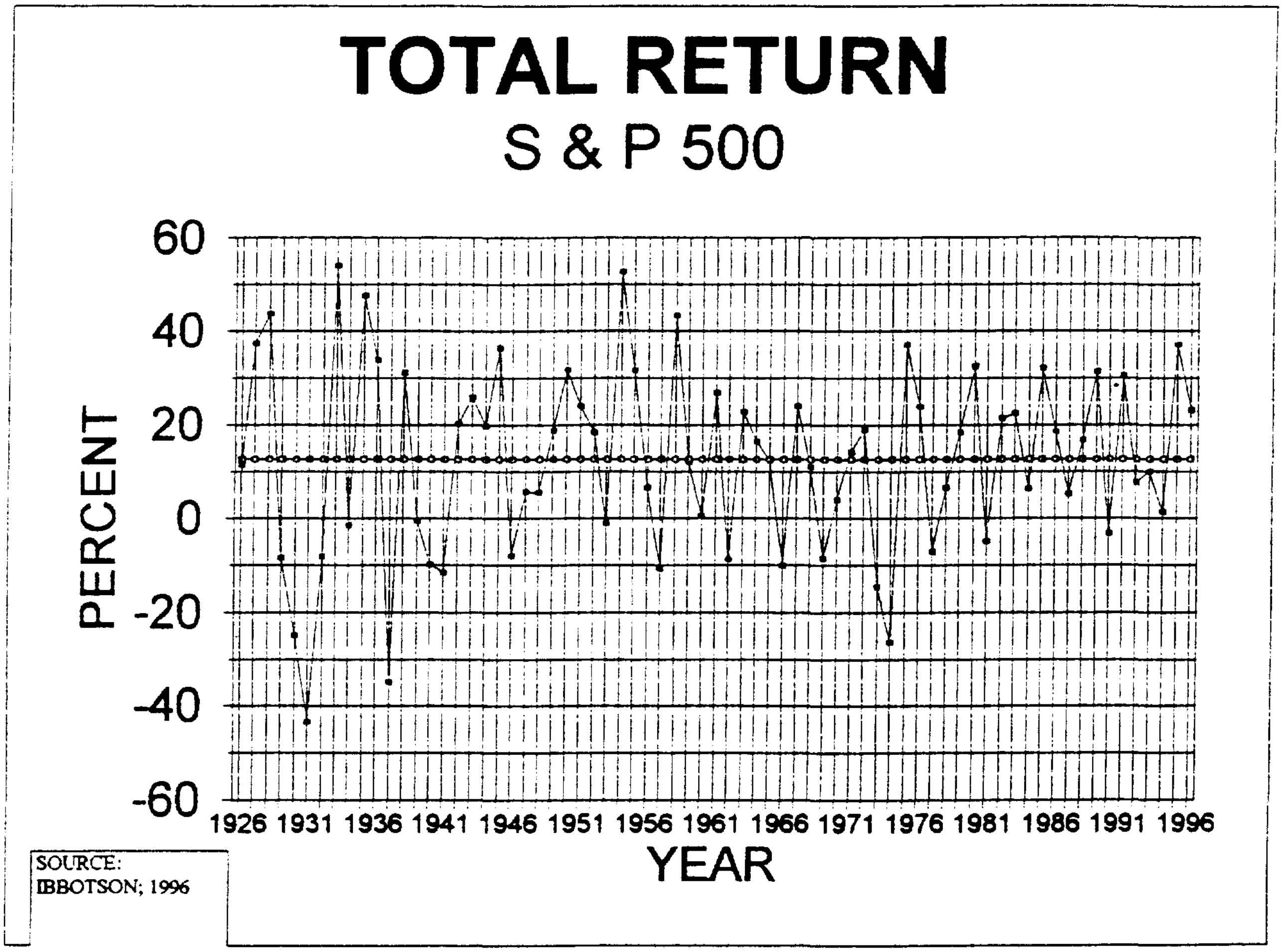
VI. CONCLUSION

LECs have thus achieved a higher total return than comparable businesses with similar financial write-offs. However, they have never taken those write-offs for regulatory purposes. The comparison companies do not get to use a regulatory set of books to seek to raise prices. The marketplace does not allow it. If LECs raise rates to recover these write-offs, they will be compensated a second time, in a way that comparison companies never are.

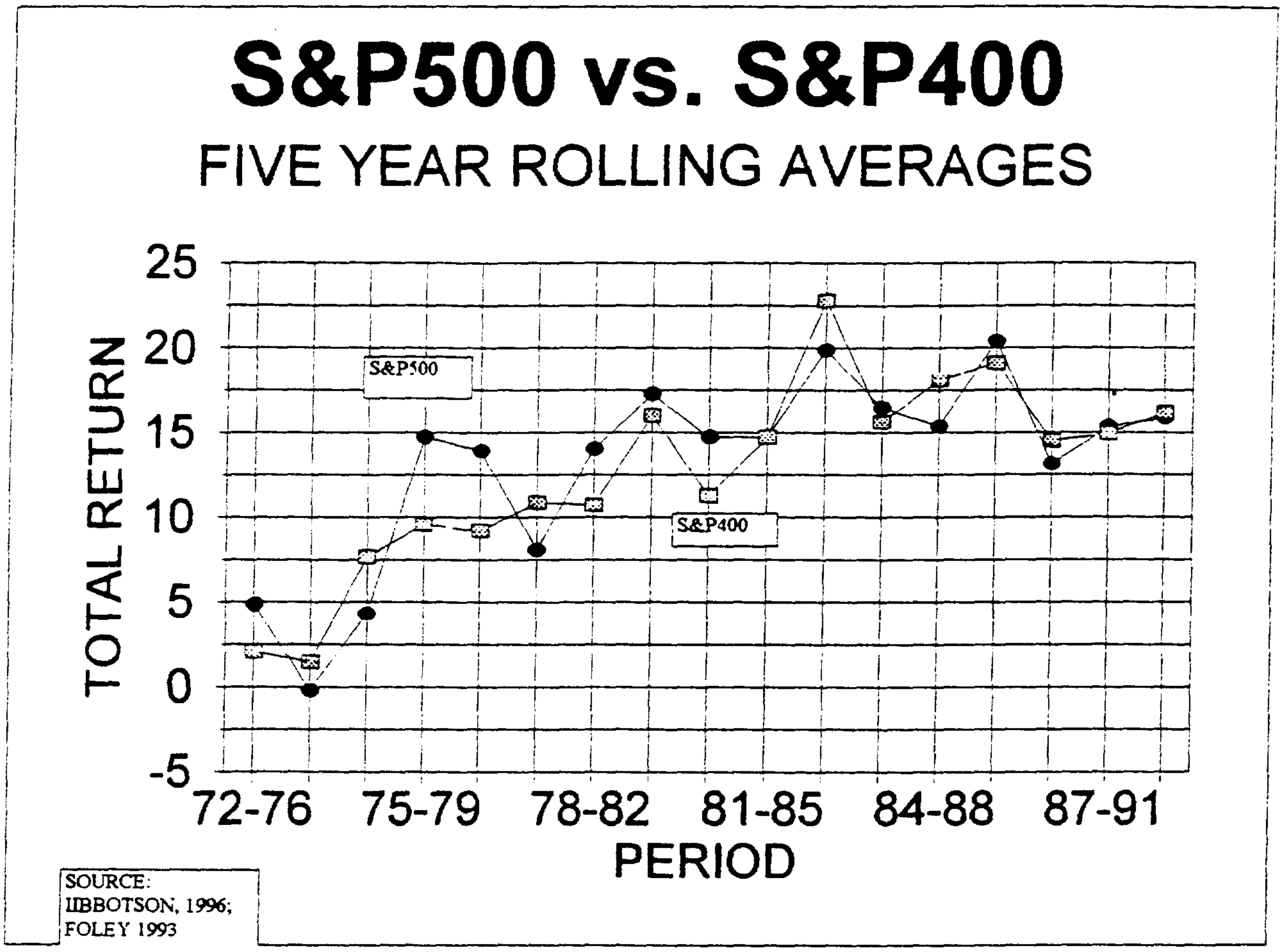
This write down of assets was part of the expectation of comparable risk. To the extent that the incumbent telephone companies have failed to take write-downs of a similar order of magnitude (relative to its assets, e.g. as a percentage of assets) on the regulatory books, they are seeking to be overcompensated for the stranding of investment. The incumbent LEC was allowed a comparable rate of return, but did not take a comparable write-down of assets. It now seeks a return of and on those assets which comparable companies have written down and taken off their books. The principles so recently adopted by the Commission should be reaffirmed and the CALLS proposal flatly rejected.


RISK FREE RETURN (10 YEAR 10-NOTE)
PERCENT INTEREST
9
8
7
6
5
4
3
2
1
0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
YEAR

ATTACHMENT MNC-2.



ATTACHMENT MNC-3



ATTACHMENT MNC-4

INCOME AND WRITEOFFS OF S&P500

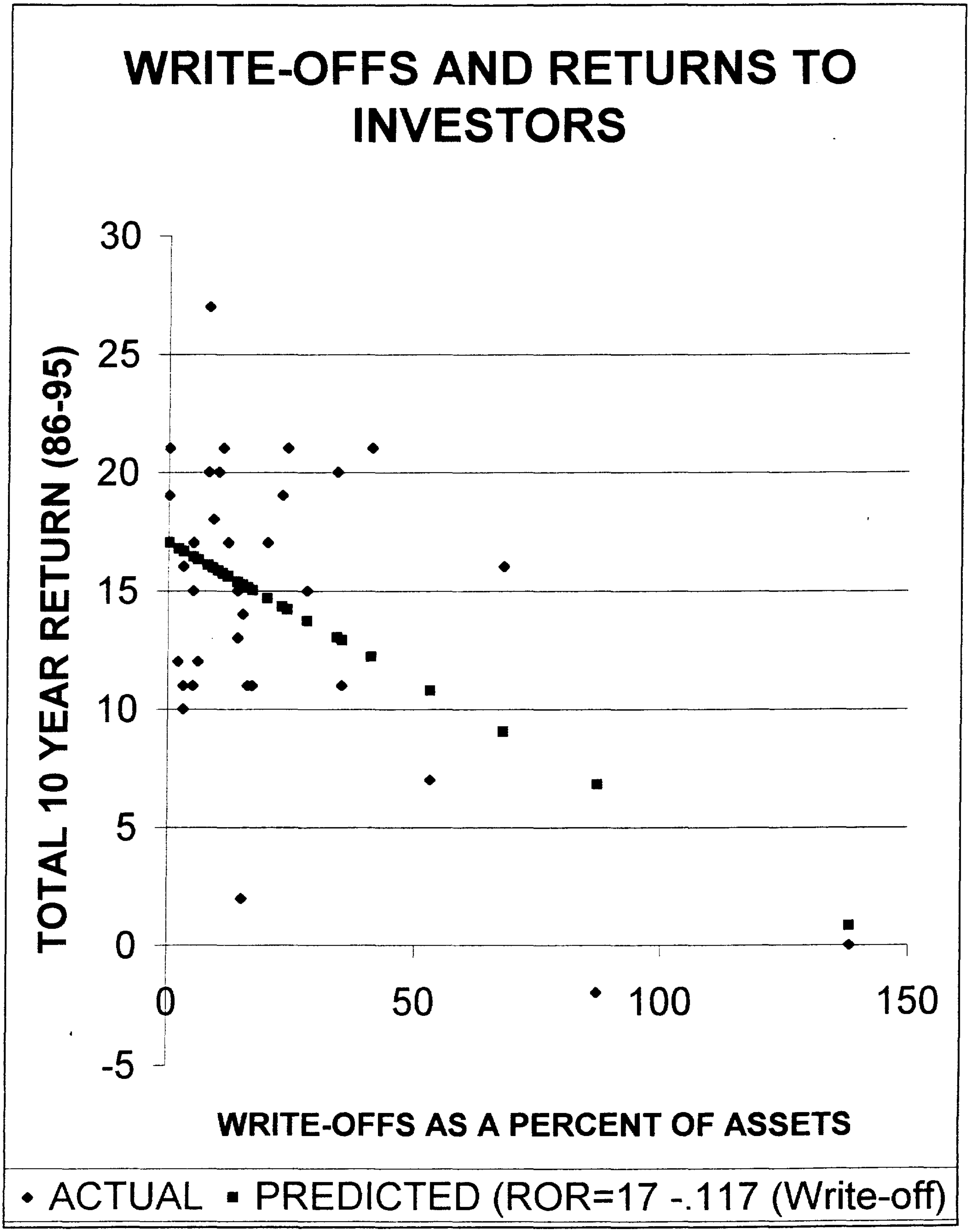
YEAR	INCOME	WRITEOFFS	WRITEOFFS AS % OF INCOME
1988	23.75	0.75	3.2
1989	22.87	2.98	13
1990	21.34	3.41	16
1991	15.91	6.29	39.5
1992	19.09	5.56	29.1
1993	21.89	6.61	30.2
1994	30.6	2.4	7.8
1995	33.96	4.83	14.2
AVERAGE	23.67625	4.10375	0.173328

Source: Goldman Sachs, The Quality of Reported Earnings Has Improved, But
January 2, 1997

ATTACHMENT MNC-5

RETURNS AND WRITE-OFFS OF COMPARISON COMPANIES

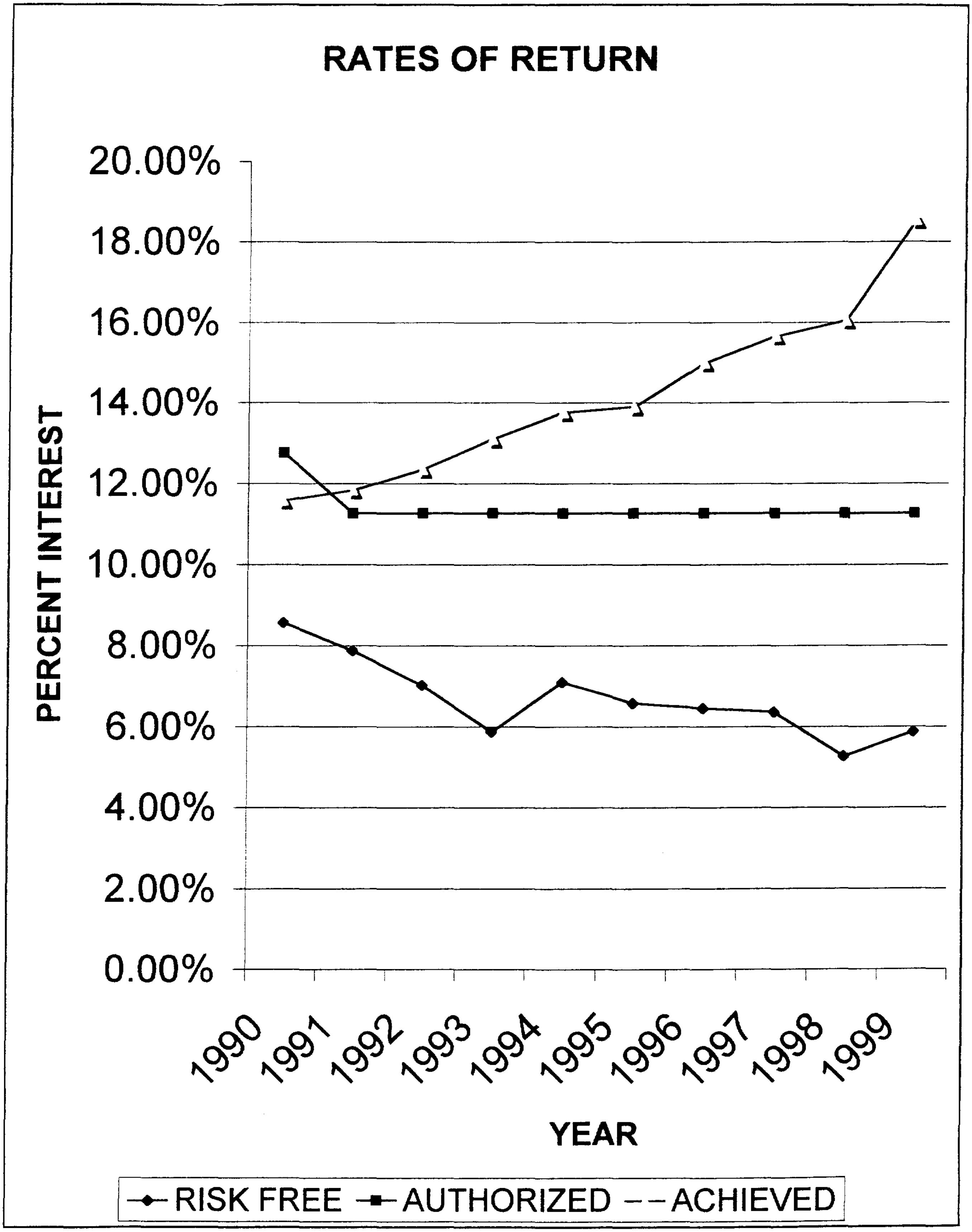
COMPANIES	TOTAL RETURN TO INVESTORS 86-95 (ANNUAL AVG.)	WRITE OFFS AND CHARGES AGAINST INCOME 86-95 % OF 95 ASSETS
AVG. COMPARISON COMPANIES	10	47
ABBOTT	20	8
ALBERTO-CULVER	12	2
AMOCO	14	15
CAMPBELL SOUP	20	34
CHEVRON	16	68
CONSOLIDATED FREIGHT	2	15
CONSOLIDATED PAPERS	11	5
DONNELLEY & SONS	12	6
DOVER	16	3
EXXON	17	5
GENERAL ELECTRIC	18	9
GENERAL SIGNAL	7	53
GARINGER	15	5
IBM	-2	87
KELLOGG	19	23
KIMBERLY-CLARK	21	41
LUBRIZOIL	11	16
MC DONALDS	19	0
MERCK	27	8
MINNESOTA MINING	15	5
NORFOLK SOUTHERN	15	14
NUCOR	21	0
PFIZER	21	24
PITNEY BOWES	17	20
PROCTOER & GAMBLE	20	10
RAYTHEON	17	12
ROCKWELL	15	28
SARA LEE	21	11
SEARS	11	35
TIME WARNER	11	3
UNION CAMP	10	3
UNION PACIFIC	13	14
WESTINGHOUSE	0	138
WHIRLPOOL	11	17


WRITE-OFFS AND RETURNS TO INVESTORS
TOTAL 10 YEAR RETURN (86-95)
30
25
20
15
10
5
0
-5
0
50
100
150
WRITE-OFFS AS A PERCENT OF ASSETS
ACTUAL
PREDICTED (ROR=17 -.117 (Write-off)

ATTACHMENT MNC-7

RETURNS AND WRITE-OFFS OF LARGE LOCAL EXCHANGE COMPANIES (LECS)

COMPANIES	TOTAL RETURN TO INVESTORS 86-95 (ANNUAL AVG.)	WRITE OFFS AND CHARGES AGAINST INCOME 86-95 % OF 95 ASSETS
LARGE LEC AVG.	17	28
BELL SOUTH	16	16
BELL ATLANTIC	16	29
AMERITECH	19	36
NYNEX	15	31
SCB	21	31
PACTEL	15	58
USWEST	12	22
GTE	18	23


RATES OF RETURN
20.00%
18.00%
16.00%
14.00%
12.00%
10.00%
8.00%
6.00%
4.00%
2.00%
0.00%
PERCENT INTEREST
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
YEAR
RISK FREE
AUTHORIZED
ACHIEVED

Further, the affiant sayeth not.

/s/

Mark. N. Cooper

SUBSCRIBED and sworn to before me this 28th day of April, 2000

TRACEY LUTZ

Notary Public, State of Maryland

My Commission Expires
June 1. 2001